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August 30, 2004

BY HAND

Mary L. Cottrell, Secretary
Massachusetts Department of Telecommunications
and Energy
One South Station, 2nd Floor
Boston, MA 02110


Re: Fitchburg Gas and Electric Light Company, D.T.E. 04-48

Dear Ms. Cottrell:

Enclosed for filing in the above-referenced proceeding, please find an original and nine (9) copies of the Initial Brief of Fitchburg Gas and Electric Light Company in the above-captioned proceeding.

Thank you for your attention to this matter.

Very truly yours,


Scott J. Mueller

SJM:cac

Enclosures

cc: Wilner Borgella, Jr., Asst. Attorney General
Kevin Brannelly, Dir., Div. of Rates and Revenue Requirements
Caroline Bulger, Hearing Officer
Paul Osborne, Rates and Revenue Division
Joseph Passagio, Rates and Revenue Division

)	
Petition of Fitchburg Gas and Electric)	
Light Company for Approval of Tariffs)	
To Provide Recovery for Costs Associated)	D.T.E. 04-48
With Its Obligations to Provide Employee)	
Pension Benefits and Post-Retirement)	
Benefits Other than Pensions)	
)	

Joe R. Miller

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COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

**Petition of Fitchburg Gas and Electric
Light Company for Approval of Tariffs
To Provide Recovery for Costs Associated
With Its Obligations to Provide Employee
Pension Benefits and Post-Retirement
Benefits Other than Pensions**

D.T.E. 04-48

**INITIAL BRIEF OF
FITCHBURG GAS AND ELECTRIC LIGHT COMPANY**

Scott J. Mueller
LeBoeuf, Lamb, Greene & MacRae, LLP
260 Franklin Street
Boston, MA 02110

Dated: August 30, 2004

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I. INTRODUCTION

On April 30, 2004, Fitchburg Gas and Electric Light Company ("FG&E or "the Company") filed with the Department of Telecommunications and Energy (the "Department") tariffs that establish an annual adjustment factor to recover costs associated with the Companies' pension and post-retirement benefits other than pensions ("PBOP") obligations that are not currently being collected in base rates. See Exh. FGE-1. The Company seeks to implement the Pension/PBOP Adjustment Factor ("PAF") for its gas division effective November 1, 2004, and for its electric division effective January 1, 2005. Id. at 085. FG&E has established, by record evidence, that the proposed mechanism is a necessary and appropriate ratemaking approach that protects the interest of customers, avoids unnecessary financial harm to the Company and is consistent with the Department's prior orders approving pension/PBOP reconciliation mechanisms. See e.g., Boston Edison Company/Commonwealth Electric Company/Cambridge Electric Light Company/NSTAR Gas Company, D.T.E. 03-47-A (2003) (the "NSTAR Order").

II. PROCEDURAL HISTORY

On June 29, 2004, pursuant to notice duly issued, the Department conducted a public hearing. The Attorney General of the Commonwealth ("Attorney General") intervened pursuant to G.L. c. 12, § 11E. Between June 16 and August 13, 2004, the Department and the Attorney General issued information requests and the Company submitted responses to all of those requests.

On August 17, 2004, the Department held an evidentiary hearing. In support of their proposal, the Companies sponsored the testimony of Laurence M. Brock, Controller of FG&E and Vice President and Controller of Unitil Service Corp. ("Service Company"), which provides management services to FG&E and other affiliates of its parent, Unitil Corporation. The

Attorney General sponsored no testimony. The evidentiary record includes 21 exhibits and six responses to record requests. The procedural schedule requires the Company and the Attorney General to submit initial briefs on August 30, 2004, and reply briefs on September 3, 2004.

III. BACKGROUND

A. Introduction

In the NSTAR Order, and other recent decisions, the Department recognized the existence of a disjunction or incongruity amongst accounting standards and tax law as they relate to pension questions and ratemaking principles and practices. NSTAR Order at 2-3; Boston Gas Company, D.T.E. 03-40, at 307-08 (2003). Previous attempts to resolve this incongruity had not succeeded, and economic events in recent years made the problem more acute. NSTAR Order at 203. In order to avoid detrimental financial consequences for utilities, and potentially for their customers, the Department concluded that it was necessary to consider a new approach to pension and PBOB recovery, one which could provide a consistent treatment of these expenses for all jurisdictional gas and electric companies. Id. at 6 and 28. Accordingly, the Department approved a reconciling annual adjustment mechanism for the NSTAR companies designed to ensure that: 1) customers pay no more and no less than the amounts actually needed to provide pension and PBOP benefits to a utility's employees; and 2) the financial health of the utility is not impaired by the volatility of pension and PBOP funding obligations. See id. at 8, and 28, 45-46. FG&E seeks approval of a similar reconciling mechanism to recover its pension and PBOP costs because it faces the same unusual economic conditions, and the unforeseen severe financial consequences those conditions lead to under the accounting standards, as previously addressed by the Department in the recent NSTAR and Boston Gas decisions. See id. at 55; Boston Gas Company, D.T.E. 03-40, at 307-309.

B. Historical Accounting, Tax and Ratemaking Treatment of Pension and PBOP Expense

In 1982, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 71 ("SFAS 71"), to be effective in 1983, which established standards for accounting for the effects of certain types of regulation. See Exh. DTE-3; NSTAR Order at 3. SFAS 71 sets forth the specific criteria that must be met for a regulated company to establish a regulatory asset. NSTAR Order at 3. A regulatory asset is an incurred cost for which a regulatory agency such as the Department allows a regulated company to record a deferral to be considered for recovery in the future. See Exh. DTE-3 at 6; NSTAR Order at 3, n. 2. Pursuant to the requirements of paragraph 9 of SFAS 71, a utility must have reasonable assurance of probable recovery of a regulatory asset over a reasonable time period, which cannot be open-ended. See Exh. DTE-3 at 6; Exh. FGE-1 at 071; NSTAR Order at 22.

In December 1985, the FASB issued Statement of Financial Accounting Standards No. 87 ("SFAS 87"), effective in 1987, which established new accounting standards that significantly changed the manner in which companies account for their obligations relating to employee pensions. See Exh. DTE-1; NSTAR Order at 3. In December 1990, the FASB issued Statement of Financial Accounting Standards No. 106 ("SFAS 106"), effective in 1993, which established accounting standards similar to SFAS 87 relating to post-retirement benefits other than pensions ("PBOP"). See Exh. DTE-2; NSTAR Order at 3.

Prior to the issuance of SFAS 87, the Department's approval of accounting treatments for pension expense varied by company. Compare Western Massachusetts Electric Company, D.P.U. 85-270, at 187-188 (1986) (pension expense based on most recent actuarial report) with

Haverhill Gas Company, D.P.U. 155, at 20-22 (1980) (pension expense based on contribution to a company-sponsored trust). Prior to the issuance of SFAS 106 the Department allowed most companies to account for their PBOP obligations on a "pay as you go" basis. This approach allowed the companies to charge PBOP costs to expense only when benefits were, in fact, paid out to or for the benefit of retirees. See Massachusetts Electric Company, D.P.U. 92-78, at 83 (1992); Bay State Gas Company, D.P.U. 89-81, at 29 (1989).

Through the issuance of SFAS 87 and SFAS 106, the FASB established a systematic method, based on annual actuarial studies and computations, for all companies to recognize employees' future retirement benefit costs as they accrue over each employee's work life. NSTAR Order at 4-5. Although FASB dictates the accounting treatment for pension/PBOP expenses, actual contributions to the pension/PBOP plans are made pursuant to the requirements of the Employee Retirement Security Act ("ERISA"), administered by the Internal Revenue Service ("IRS"). Id. SFAS 87 and SFAS 106 standards and IRS/ERISA requirements are not the same, even though they relate to the same areas of costs. Id. The IRS' rules allow for and limit the tax deduction of contributions to pension and PBOP plans. Since the issuance of SFAS 87 and SFAS 106, treatment of pension and PBOP expenses for accounting purposes may be, and usually is, different from actual contributions to pension/PBOP plans. Id.

The changes in accounting rules required the Department to reexamine how best to include a representative level of pension/PBOP expenses in base rates. See D.P.U. 89-81 at 29-35; Western Massachusetts Electric Company, D.P.U. 87-260, at 39-47 (1988). Typically, the Department used an amount equal to the test year cash contribution to the pension plan as the representative level of pension expense to include in rates. See e.g., Commonwealth Electric Company, D.P.U. 89-114/90-331/91-80 Phase One at 65-66 (1991); Western Massachusetts

Electric Company, D.P.U. 88-250, at 67-72 (1989); D.P.U. 87-260, at 44-47. Regarding PBOP expense, the Department balanced the competing interests of (1) SFAS 106 and (2) the need to allocate PBOP expenses appropriately and in a cost-effective manner. See e.g., D.P.U. 96-50 (Phase I) at 81; see also Cambridge Electric Light Company, D.P.U. 92-250, at 54 (1993).

The Department recognized that it was, however, progressively more difficult to determine representative levels of pension and PBOP expenses for inclusion in base rates and, further, to determine a base-rate treatment method applicable both to all regulated companies and to all circumstances that may reasonably be expected to arise between rate cases. See NSTAR Order at 6. Because of the volatility involved with the SFAS 87 and SFAS 106 actuarial expense calculations, and the differences between those calculations and the calculation of the IRS tax-deductible contribution, until recently the Department adopted varying ratemaking methodologies depending on the circumstances of the case. Exh. FGE-1 at 070. To address this incongruity, the Department determined in 2003 that it needed to consider a new approach to pension and PBOP recovery for jurisdictional gas and electric companies, and approved annual reconciling adjustment mechanisms for Commonwealth Electric Company, Cambridge Electric Company, Boston Edison Company, NSTAR Gas Company and Boston Gas Company. See NSTAR Order at 6; Boston Gas Company, D.T.E. 03-40; see also Aquarion Water Company of Massachusetts, D.T.E. 03-91 (Dec. 29, 2003) (approving deferral of difference between pension/PBOP expenses and amounts included in base rates for future recovery through a reconciling mechanism).

C. FG&E Pension and PBOP Expense

FG&E provides pension benefits to its employees through the Unitil Corporation Retirement Plan ("Pension Plan") which provides monthly retirement income to employees who

qualify for a retirement benefit. Exh. FGE-1 at 065. The Pension Plan maintains an investment trust fund for the management of the plans assets and the funding of current and future retiree pension benefits. Exh. FGE-1 at 065-66 and Exh. LMB-2. The current Pension Plan is a consolidated retirement plan that resulted from the merger of several prior plans of FG&E and other Unitil affiliates in 1998. Id.

Between January 1993 and December 2003, FG&E provided PBOP benefits to its employees through the Unitil Retiree Trust, a special purpose entity ("SPE") that allowed the Unitil companies to continue to account for certain of its PBOP obligations on a "pay as you go" basis even after the effective date of SFAS 106. Exh. FGE-1 at 067, 074-75. Accordingly, during this period, FG&E recorded annual PBOP expense in an amount equal to the actuarially determined SFAS 106 costs for current employees plus a "pay as you go" amount for retirees, which were funded through Unitil's SPE, the Unitil Retiree Trust ("URT"). Exh. FGE-1 at 074-75.

In late 2003, however, the accounting rules for SPE's were changed by the issuance of FASB Interpretation No. 46(R), "Consolidation of Variable Interest Entities" ("FIN 46") which required FG&E to move from cash based accounting, for those PBOP expenses previously provided by URT, to an accrual basis of accounting. Exh. FGE-1 at 074-75; Exh. DTE-4. As a result, URT was dissolved and the Company established irrevocable trusts for making tax-deductible contributions for its PBOP obligations. Exh. FGE-1 at 074-75.

In its most recent base rate case, the Department approved recovery of FG&E's Pension/PBOP costs based on test year costs for 2001 as adjusted for known and measurable amounts. Fitchburg Gas and Electric Light Company, D.T.E. 02-24/25 at 111 and 122 (2002). Based upon an actuarial calculation required under SFAS 87, FG&E recorded income on its

pension fund during the test year and thus included zero pension expense for ratemaking purposes. Exh. FGE-1 at 079. In regards to FG&E's PBOP expense, the Department found that FG&E's SFAS 106 costs for 2002 was representative of FG&E's SFAS 106 benefit cost and that FG&E's 2002 cash funding of the Unitil Retiree Trust was a known and measurable change to FG&E's test year cost of service. Id. The total pension/PBOP expenses recovery in base rates is \$594,677. See Exh. DTE-9, Sch. LMB-4 (Revised 8-12-04).¹

D. Recent Department Precedent on Pension and PBOP Expense

In late 2002, FG&E became aware of a significant potential increase in its pension expense and liability due to the decline of the capital markets, falling interest rates and certain accounting requirements. See D.T.E. 02-83 (FG&E Filing) (Dec. 12, 2002). Accordingly, on December 12, 2002, FG&E requested an accounting order from the Department in order to mitigate the severe financial consequences resulting from the declining markets, and the "incongruity" among certain accounting standards, tax laws and ratemaking treatment for employee pension and PBOP expenses. Id. FG&E requested, and the Department granted, approval for FG&E to record its Additional Minimum Liability ("AML") associated with its employee pension obligations as a regulatory asset under SFAS No. 71 in order to avoid an estimated \$4.6 million write down of common equity. See Fitchburg Gas and Electric Light Company, D.T.E. 02-83 (Dec. 20, 2002). At the same time, the Department also approved a similar request of the NSTAR Companies to avoid a significant write down of common equity by: 1) creating a regulatory asset for the under funded amount in the Companies' pension plan and 2) deferring the difference between their pension and PBOP expenses recorded under the

¹ FGE's initial filing incorrectly stated the amount of pension/PBOP recovery in base rates (\$604,364) because of a transcribing error which misstated the amount of Unitil Service PBOP expense included in rates. Exh. DTE-9; Tr. at 83.

accounting rules and the amount collected in base rates. See Boston Edison Company/Commonwealth Electric Company/Cambridge Electric Company/NSTAR Gas Company, D.T.E. 02-78 (Dec. 20, 2002).

On October 31, 2003, the Department approved the requests of the NSTAR Companies to establish an annual adjustment factor to recover costs associated with their pension and PBOP obligations that are not currently being collected in base rates. NSTAR Order, D.T.E. 03-47-A (Oct. 31, 2003). In granting that approval, the Department noted its objective of developing "a consistent practice and treatment" of pension and PBOP expenses for all jurisdictional gas and electric companies. Id. at 6. The Department also recognized that in order to allow the NSTAR Companies to continue to recognize a regulatory asset for their pension and PBOP expense, and avoid a significant reduction in common equity, it must specify a definite period of recovery to meet the "probable recovery" requirement under Paragraph 9 of SFAS No. 71. Id. at 24. Accordingly, the Department approved a pension and PBOP annual rate adjustment factor for the NSTAR Companies. Id.

On January 28, 2003, the Department approved a request by Boston Gas for an accounting ruling similar to the deferral request previously discussed for the NSTAR Companies, as related to pension expense. See Boston Gas Company, D.T.E. 03-40 at 301-302. The Boston Gas request dealt only with pension costs because it was already reconciling its PBOP expense with the amount collected in rates and recording any difference in a deferral account. Id. In D.T.E. 03-40, Boston Gas' most recent rate case, it proposed a reconciling mechanism similar to the approved NSTAR rate adjustment mechanism for the pension expense deferral. Id. at 302-303. The Department authorized Boston Gas to begin recovering on November 1, 2003, outside of base rates, its test year SFAS-determined pension expense. Id. at

313. On September 15, 2004, and every year thereafter, Boston Gas will commence reconciling its SFAS-determined pension expense for the prior calendar year, plus previously unamortized balances, with the amount included in rates for that period, and amortize the amount over three years ("Reconciliation Amount"). Id.

In addition, consistent with NSTAR's rate adjustment mechanism, Boston Gas was allowed to recover carrying costs applied to the average annual prepaid pension balance expense and the unamortized deferred pension expense, net of deferred taxes. Id. at 311-312. The Reconciliation Amount and the carrying costs are collected from, or refunded to, customers on an equal cents per therm basis over the following twelve months through the Boston Gas' Local Distribution Adjustment Factor ("LDAC"). Id. at 313-314. In a subsequent order issued in D.T.E. 03-40-A (in response to Boston Gas' Motion for Clarification) the Department clarified its initial order to provide for the recovery of PBOP deferrals, as well as carrying charges on deferred PBOP balances, through the annual adjustment mechanism. Boston Gas Company, D.T.E. 03-40-A at 7.

Subsequent to the Department's decisions in D.T.E. 03-40 and D.T.E. 03-47-A, FG&E filed with the Department a request for an accounting order granting authorization to defer, and record as a regulatory asset, certain pension and PBOP related costs above the level of costs included in base rates. Fitchburg Gas and Electric Light Company, D.T.E. 03-131, (FG&E Filing) (Dec. 15, 2003). Specifically, FG&E sought an accounting ruling that permits it to defer, and record as a regulatory asset, the difference, for the year 2003, between its pension and PBOP costs in base rates and the amounts that are required to be booked in accordance with SFAS 87 and SFAS 106. Id. at 1. On that date, FG&E also notified the Department that, in light of the NSTAR decision in D.T.E. 03-47-A, it was preparing a filing to implement an annual

reconciliation adjustment mechanism for the costs that were the subject of the deferral request. Id. at 4. FG&E's request for regulatory asset accounting and deferral was approved by the Department on February 5, 2004. See Fitchburg Gas and Electric Light Company, D.T.E. 03-131 (Feb. 5, 2004).

IV. DESCRIPTION OF THE COMPANY'S PROPOSAL

The design of FG&E's PAF is based upon the Department's precedent approving the pension adjustment mechanism for NSTAR and Boston Gas and is designed to conform to that precedent as applied to FG&E's particular circumstances. Exh. FGE-1 at 064, 071-073; Exh. DTE-12; Tr. 8/17/04 at 23-24. To expedite the Department's review of the proposed PAF, FG&E included with its April 30, 2004 filing redlined versions of the proposed tariffs, showing changes from the tariffs approved for NSTAR in D. T. E. 03-47-A, along with clean versions of the proposed tariffs for both the gas and electric divisions. Exh. FGE-1 at 027-054. No revisions to the gas division rate schedules are required since the PAF will be included in the Local Distribution Adjustment Charge ("LDAC") which is already reflected in the gas division rate schedules. Exh. FGE-1 at 001-026. The proposed PAF is an annually reconciling mechanism designed to recover FG&E's incremental Pension/PBOP expense over the amounts currently in base rates. Exh. FGE-1 at 060.

The proposed PAF either reconciles and recovers, or reconciles and refunds, the annual amount booked by FG&E in accordance with SFAS 87 and SFAS 106 with the annual Pension and PBOP expense amount included in the Company's base rates. Id. at 081-84. The proposed PAF is calculated in the same way for both the electric and gas divisions. Id. FG&E's Pension and PBOP costs are considered common employee costs for accounting purposes, however, and therefore an allocation methodology is used to assign Pension and PBOP costs to each division

which is consistent with the common cost allocation methodology approved by the Department in FG&E's last base rate case, D.T.E. 02-24/25. Exh. FGE-1 at 082.

Consistent with the approved reconciliation adjustments for NSTAR and Boston Gas there are three components to the proposed PAF: 1) one third of the Unamortized Reconciliation Deferral at the end of the prior year, which is calculated as the unamortized Pension/PBOP deferral balance at the beginning of the prior calendar year; plus a reconciliation of the SFAS-determined Pension/PBOP expense for the prior calendar year with the amount included in base rates (the Reconciliation Deferral for the prior year); minus the Reconciliation Adjustment for the prior calendar year, amortized over three years ("Reconciliation Adjustment"); 2) a calculation of Carrying Charges applied to (a) the unamortized pension/PBOP deferral balance at the end of the prior calendar year, net of deferred taxes; and (b) the average prepaid pension/PBOP assets, or accrued pension/PBOP liabilities for the prior calendar year, net of deferred taxes; and 3) the past period reconciliation amounts which represent the differences between the prior period's actual Pension/PBOP adjustment amount and the amount actually collected from customers, with interest at the prime rate. Exh. FGE-1 at 082-84. The sum of these calculations is divided by the forecasted sales units to arrive at the PAF for the upcoming (i.e., current) year. Exh. FGE-1 at 082-084; Exh FGE-1, Schedule LMB-1.

FG&E is proposing an effective date of November 1, 2004, for the gas division tariffs in order to implement the rate change at the same time as the effective date of its next Cost of Gas Adjustment ("CGA") and LDAC. Exh. FGE-1 at 085. The company is proposing an effective date of January 1, 2005, for the electric division tariffs in order to coincide with its annual reconciliation and rate filing for effect January 1, 2005. Id. FG&E's proposal would increase rates by \$556,672 for the electric division and \$416,899 for the gas division. Exh. DTE-9,

Schedule LMB-1 (Revised 8/12/04) at line 31. FG&E's proposed PAF for the gas division is \$0.0160 per therm and for the electric division is \$0.00102 per kWh. Exh. DTE-1-9, Schedule LMB-1 (Revised 8/12/04) at line 33.

V. ARGUMENT

The PAF as proposed by FG&E is based upon recent Department precedent which recognizes the need to provide for the recovery of deferred pension and PBOP expenses within a reasonable period of time to comply with the requirements of SFAS 71 and avoid detrimental financial consequences for gas and electric companies. See D.T.E. 03-40 at 309; NSTAR Order at 22-24. In approving this new methodology for recovery of pension and PBOP expenses, the Department has considered three factors traditionally applied when determining whether an expense category should be recovered under a reconciling mechanism: 1) the magnitude and volatility of the expense; 2) the role of accounting requirements, rather than the Company's actions, on the expense volatility; and 3) the effectiveness of the reconciling mechanism in avoiding the negative effects of the expense volatility. See D.T.E. 03-40 at 309.

The record in this case has established that FG&E faces volatile pension and PBOP expenses which may have severe financial consequences for the Company absent approval of the proposed PAF. Exh. FGE-1 at 076-077. FG&E has also demonstrated that the volatility of these expenses is the result of accounting requirements, falling interest rates and equity market fluctuations outside of the Company's control. Exh. FGE-1 at 074. The record in this proceeding also shows that FG&E's proposed reconciling mechanism will avoid the negative effects of the pension expense volatility, including adverse impact on the Company's financial health and the creation of a perpetual cycle of base rate cases. Exh. FGE-1 at 078. The Department should thus approve FG&E's proposed reconciling mechanism because the Company's particular circumstances support the application of the Department's recent

precedent. FG&E's proposal is consistent with Department precedent and will ensure that ratepayers pay no more and no less than the Company's pension and PBOP costs.

A. FG&E'S PROPOSED PAF IS CONSISTENT WITH DEPARTMENT PRECEDENT

As discussed in Section IV, the design of FG&E's PAF is based upon the Department's precedent approving the pension adjustment mechanism for NSTAR in D.T.E. 03-47-A and Boston Gas in D. T. E. 03-40 and is designed to conform to that precedent as applied to FG&E's particular circumstances. Exh. FGE-1 at 064; Exh. FGE-1 at 071-073; Exh. DTE-12; Tr. 8/17/04 at 23-24. The formula for calculating the PAF is the same as the Department approved in D.T.E. 03-47-A. Exh. FGE-1 at 029-31, 034-36 (red-lined version of FG&E's proposed tariff compared to NSTAR's approved tariff). For the gas division the formula is:

$$PAF_x = (RA_x + cc(URD_x + APPA_x - DTA_x) + PPRA_x) / F_{therm_x}$$

PAF = The annual Pension/PBOP Adjustment Factor.

RA_x = The Reconciliation Adjustment for Year x , is one-third of the Unamortized Reconciliation Deferral at the end of the Prior Year.

URD_x = The Unamortized Reconciliation Deferral is the amount of the Reconciliation Deferral that has not yet been collected in retail rates. At the beginning of Year x the Unamortized Reconciliation Deferral is the sum of: (1) the Unamortized Reconciliation Deferral at the beginning of the Prior Year; plus (2) the Reconciliation Deferral for the Prior Year; minus (3) the Reconciliation Adjustment for the Prior Year.

cc = The Cost of Capital is the tax-effected weighted-average cost of capital as most recently approved by the Department. Until the Company's next general rate case following the effective date of this tariff, the Cost of Capital shall be 11.10 percent.

$APPA_x$ = The Average Pre-Paid Amount, for Year x is one half of the sum of: (1) the Pre-Paid Amount recorded on the Company's books as of the beginning of the Prior Year; and (2) the Pre-Paid Amount to be recorded on the Company's books as of the end of the Prior Year.

DTA_x = The Deferred Tax Amount is the deferred taxes associated with (i) the Average Pre-Paid Amount and (ii) the URD at the end of the Prior Year.

PPRA_x = The Past Period Reconciliation Amount is the sum of: (a) the difference between (1) the amount of PAF revenue that should have been collected by the Company in the year preceding the Prior Year and the Prior Year; and (2) the amount of PAF revenue actually received by the Company in the year preceding the Prior Year and the Prior Year; and (b) the amount computed in clause (a) times the prime rate computed in accordance with 220 C.M.R. § 6.08(2).

Ftherm_x = The Forecasted Therms is the forecasted amount of therms to be distributed to the Company's distribution customers for the upcoming annual PAF billing period.

The formula for the electric division is the same except that in the final step the amount is divided by forecasted kilowatt hours rather than by forecasted therms. Id.

In calculating the PBOP expense for the prior calendar year, and the Unamortized Reconciliation Deferral at 12/31/03, for amortization and inclusion in the proposed PAF, the Company reduced the per book PBOP expense by the portion applicable to the transition obligation before calculating the amount of PBOP expense that is chargeable to construction overheads. Exh. FGE-1, Schedule LMB-2, lines 9 and 14; Exh. FGE-1, Schedule LMB-5, lines 10 and 14; Exhibit DTE-11; Tr. 8/17/04 at 57. FG&E did not capitalize the transition obligation because this amortization amount is separated from the amounts chargeable to current construction overheads in order to avoid charging current construction projects for prior period costs. Exh. DTE-12; Tr. 8/17/04 at 57. As explained by Mr. Brock:

The Company's calculation provides an application of the accounting standards where the matching of current-period expenses to the current period is the objective. In carving out the transition obligation from the construction overheads, the Company made the step of taking a material figure and excluding it from the capitalization into construction overheads. And the complement to that calculation is that the amount does wind up in the current amortization of costs in current operating expenses. And the Company's position is that that's a better matching from an accounting standpoint of revenues and expenses with period costs.

Tr. 8/17/04 at 57-58.

The proposed PAF reflects the amortization of the prior period Unamortized Reconciliation Deferral over a three year period. Exh. DTE-9, Schedule LMB-1 (revised 8/12/04), line 7. In arriving at the proposed three year amortization period, the Company reviewed the SFAS 71 probable recovery standard in Paragraph 9 with the Company's outside auditors, Grant Thornton, who indicated that an amortization period of three to seven years was reasonable under that standard. Tr. 8/17/04 at 102. Subsequent to this review the Company did not consider an amortization period longer than three years because this period appeared reasonable within the probable recovery standard in Paragraph 9 of SFAS 71 and was consistent with the precedent set in the NSTAR Order. Tr. 8/17/04 at 101-102; NSTAR Order at 45

The calculation of carrying charges on the unamortized deferral balance and the prepaid assets or liabilities uses the pre-tax weighted cost of capital. Exh. FGE-1 at 084. Exh. FGE-1, Schedule LMB-1, lines 13-23; Exh. FGE-1, Schedule LMB-6. As the Department found in approving the NSTAR Reconciliation Mechanism in D. T. E. 03-47-A, however, the weighted cost of capital would be applied to both rate base and pension expense if the reconciliation adjustment were proposed within the context of a § 94 general rate case, which the Department determined to be the nearest comparable exercise to the review of the NSTAR Reconciliation Mechanism proposal. NSTAR Order at 40. The Department further found that it also applies the weighted cost of capital to cash working capital which, like pension expense levels, fluctuates over time but is a permanent expense creating a long term financing requirement. Id. at 41.

The proposed PAF is a uniform per kilowatt hour or per therm charge consistent with the reconciliation mechanisms approved for NSTAR and Boston Gas. See Exh. FGE-1 at 029-31, 034-36, 085. FG&E has not proposed to collect any portion of the PAF through the demand portion of customer's bills. Traditionally, most reconciling mechanisms approved by the

Department are collected on a per kilowatt hour or per therm basis, including the cost of gas adjustment clauses, default service charges and energy efficiency charges. See e.g., Petition of Western Massachusetts Electric Company, D.T.E. 97-120/03-125 (Dec. 29, 2003).

B. THE APPROVAL OF THE PROPOSED PAF AVOIDS SIGNIFICANT AND ADVERSE FINANCIAL IMPACTS ON THE COMPANY AND ITS CUSTOMERS

FG&E, like other Massachusetts utilities, has experienced higher Pension/PBOP costs in recent years due to the decline in the stock market and the sharp fall in interest rates which, taken together, have had a significant upward impact in the amount of Pension/PBOP costs that must be recognized under SFAS 87 and FAS 106. Exh. FGE-1 at 074. FG&E has also experienced a significant increase in PBOP expense in 2003 due to changes required under FIN 46, which required the Company to move from cash based accounting for those expenses previously provided by the URT to an accrual basis of accounting. Exh. FGE-1 at 074-075.

In the absence of the proposed PAF, the Company and its customers will face detrimental (and unnecessary) financial consequences relating to extraordinary charges against common equity. Exh. FGE-1 at 068 and 076-078; Exh. DTE-5; Tr. 8/17/04 at 73. As FG&E has pointed out in its letters to the Department in 2002 and 2003 requesting Regulatory Asset treatment for the difference between current Pension/PBOP costs and the amount currently collected in base rates, FG&E would have been required to take a charge to equity, through Other Comprehensive Income, of \$4.6 million in 2002 and \$4.2 million in 2003, amounting to approximately 15% of FG&E's total equity. Exh. FGE-1 at 076; Tr. 8/17/04 at 73. The magnitude of this potential charge to FG&E's equity would certainly affect the company's credit quality and therefore impair FG&E's ability to raise capital in the future to support its ongoing annual program to invest in significant utility plant additions and improvements. Exh. FGE-1 at 077. As the Department and the Supreme Judicial Court have recognized, a serious threat to a utility's financial integrity may

translate into adverse effects on ratepayers, including higher future rates, higher borrowing costs and the potential for deterioration in service from a financially-strapped utility. See NSTAR Order at 25-27 citing Attorney General v. Dept. of Public Utilities, 390 Mass. 208, 229 (1983). Also, the additional expense amount that would have been recognized of approximately \$2.2 million would have constituted an increase of approximately \$1.5 million over the amount collected by FG&E in base rates for Pension/PBOP costs, or approximately 15% of the total amount of operating and maintenance expenses collected by FG&E in base rates. Exh. FGE-1 at 076.²

In the absence of the proposed PAF the financial impact to FG&E's customers would be significant due to the potential for increases in base rates, and the potential for reduced service quality due to being served by a financially-strapped utility. Exh. FGE-1 at 077. Further, FG&E's customers would be paying either too much or too little through base rates for Pension/PBOP costs, as well as absorbing the costs of frequent base rate cases in their electric and gas base rates. Exh. FGE-1 at 077; NSTAR Order, at 26-27. The Department has recognized that some write-downs pose the threat of serious financial repercussions to utility operations in the form of higher rates and lower quality of service to ratepayers. Boston Edison Company, D. P. U. 906, at 154-258; NSTAR Order at 25. The Department determined in the NSTAR Order that failure to adopt a pension and PBOP reconciling mechanism would

² As the Department noted in the order approving the Pension/PBOP Reconciliation Mechanism for NSTAR, in order to allow the NSTAR Companies to continue to recognize a regulatory asset for their pension and PBOP expense, and avoid a significant reduction in common equity, "a definite period of recovery must be specified" to meet the "probable recovery" requirement of SFAS No. 71. Boston Edison Company/Commonwealth Electric Company/Cambridge Electric Company/NSTAR Gas Company, D.T.E. 03-47-A, at 24 (2003). Accordingly, the Department approved a Pension/PBOP annual rate adjustment for the NSTAR Companies to avoid triggering an equity write-down entailing significant financial consequences for the Companies. Id. The Department reiterated the precedent set in the NSTAR proceeding in Boston Gas Company's most recent rate case where Boston Gas proposed, and the Department approved, a reconciling mechanism similar to the NSTAR rate adjustment factor, Boston Gas Company D.T.E. 03-40 (2003).

inevitably trigger a write-down entailing significant, and impairing, financial consequences for the Companies. NSTAR Order at 25-26.

C. THE APPROVAL OF THE PROPOSED PAF MITIGATES THE VOLATILITY OF PENSION/PBOP EXPENSE, WHICH IS OUTSIDE OF THE COMPANY'S CONTROL

The level of FG&E's Pension and PBOP expense that is required to be recognized in any given year is a function of accounting requirements, which are beyond the control of the Company. See D.T.E. 03-131 at 3. In approving NSTAR's Pension/PBOP Reconciliation mechanism, having found that the Companies required recovery of the Pension/PBOP Deferral should take place within three to five years, and ultimately adopting a three year amortization period, the Department went on to determine that the historical approach to pension cost recovery does not establish a set date for recovery and therefore does not meet the requirements of SFAS 71. NSTAR Order at 27. The Department found that there was every reason to believe that a perpetual cycle of rate cases could take place, driven by the accounting rules rather than by sound ratemaking principles or customer interests and that there was a need to consider a new approach to Pension/PBOP recovery. Id. The Department approved the proposed reconciliation adjustment mechanisms for the NSTAR Companies and Boston Gas, establishing a consistent practice and treatment of pension and PBOP expenses. See id. at 6 and 27-28.

The volatility of pension/PBOP expense is evidenced in FG&E's experience over the past few years. In FG&E's most recently concluded base rate cases in D.T.E. 02-24/25 the Department approved new base rates for FG&E which reflected a 2001 test year proformed to include no pension expense due to the Company being in a fully funded position. See D.T.E. 02-24/25 at 111-112 (Dec. 2, 2002). In contrast, at the time of the Company's filing of its request for an Accounting Order on December 12, 2002 the Company expected to incur a pension expense of over \$200,000 in 2003 and make cash contributions to the pension plan. See D.T.E.

02-83 at 1. Due to the FASB accounting requirements relating to FG&E's pension plan assets and the substantial decline in the capital markets, FG&E was also facing a year end reduction in equity in the amount of \$4.6 million associated with the reversal of prepaid pension cost of \$3.9 million and recognition of the 2002 unfunded Accumulated Benefit Obligation ("ABO") of \$0.7 million. Id. at 2.

While it could be expected that, because of improved market conditions, the under funding of the pension plan would have decreased since 2002, the AML at the end of 2003 remains at approximately \$4.2 million. Tr. 8/17/04 at page 77. If market conditions improve, and pension expense stabilizes for a period of time, the option to revert back to historical rate case recovery of Pension/PBOP expense in future rate cases for Massachusetts jurisdictional gas and electric utilities always exists. However, as Mr. Brock testified to, and as the Department has recognized: "the volatility that we have seen in the capital markets and with discount rates and needing to deal with that volatility in ratemaking and accounting rules has been a difficult situation for companies in the last couple of years. I can't predict that that won't continue." Tr. 8/17/04 at page 79.

The proposed PAF eases the impact of the volatility of pension and PBOP expenses for the Company and its customers and is the most equitable solution to the recovery of FG&E's Pension/PBOP costs. For customers, the PAF will reconcile the costs and revenues so that customers pay only the amounts necessary for the Company to fulfill its pension and PBOP obligations. Exh. FGE-1 at 078. Rather than large and "permanent" changes in cost recovery established through general rate cases, the three year amortization of the difference between the SFAS expense and the amount being collected in base rates systematically phases-in rate changes annually. Rates in the future will rise and fall more gradually and with certainty, thus

reducing rate volatility and protecting customers from overpaying. The PAF would permit the Company to continue to defer expenses as Regulatory Assets and provide FG&E with a systematic and predictable recovery of its Regulatory Assets with carrying costs, therefore protecting the financial integrity of the Company along with protecting customers from the adverse impacts of impairment to FG&E's financial integrity. Exh. FGE-1 at 078. The Company's earnings and equity would be protected from the volatile swings of financial markets that cause large sudden changes in earnings and potentially significant and material charges to equity, which are mandated by accounting rules. Lastly, the PAF would encourage FG&E to pre-fund its Pension/PBOP obligations in order to maximize funding of the obligations from tax deductions and tax advantaged investment growth, thereby minimizing the future amounts required to be collected from customers. Exh. FGE-1 at 078; Exh. DTE-7.

D. THE PROPOSED PAF IS DESIGNED TO AVOID UNNECESSARY RATE CASES AND ENSURE THAT CUSTOMERS PAY NO MORE AND NO LESS THAN THE AMOUNTS NEEDED TO PROVIDE PENSION AND PBOP BENEFITS TO FG&E'S EMPLOYEES

As the Department noted in the NSTAR Order, a utility could still maintain a regulatory asset for its pension and PBOB expense and avoid a charge to equity by promptly filing rate cases. NSTAR Order at 27-28. While a base rate case might provide a short term fix, it

"does not represent a long-term solution to the Department's chronic dilemma of setting a representative level for pension costs and resolving the incongruity amongst FASB standards, ERISA/IRS, and regulatory ratemaking."

Id. The absence of a separate mechanism to adjust rates to provide for the timely recovery of the Company's potentially volatile pension and PBOP obligations could create a "perpetual cycle of rates cases, driven principally by the accounting rules rather than by sound ratemaking principles or customer interest." Id.

When markets deteriorate, as has been the case in recent years, the increased expense may force utilities to file general rate cases to recover the increased costs. In the absence of approval of the PAF tariffs, the immediate filing of rate cases for the electric and gas divisions may be the only option available to the Company over the short term. FGE Exh. 1 at 077. Over the long term, the lack of a separate reconciliation adjustment mechanism would likely trigger a series of rate cases. See NSTAR Order at 28. If financial markets deteriorate further, the Company would be required to file more general rate cases in order to recover its costs. If financial markets improve (and the level of pension and PBOP expenses decline), the Attorney General or the Department would likely seek to reduce the Company's rates.

A potential cycle of unnecessary and costly rate cases benefits no one. Such cases would reflect increases in costs unrelated to pension and PBOP obligations, including the cost of filing and litigating such rate cases. The filing of repeated rate cases to reflect changes in pension and PBOP expenses could also place a burden on the resources of the Department, intervenors and the Company, with no incremental benefit to the Company or its customers.

FG&E's recent experience with the volatility of its pension and PBOP obligations demonstrates the necessity of a different approach consistent with the Department's determination in D.T.E. 03-47-A. Within months of the closing of the record in FG&E's last base rate case, in which it had zero pension expense, the Company learned from its actuaries of its significant exposure to an equity reduction based upon the decline in the capital markets. See FG&E, D.T.E. 02-83 (Dec. 20, 2002). Less than a year later, the Company also had to adopt FIN 46, and change from the "pay as you go" method of accounting to accrual accounting for its PBOP obligations, increasing its annual PBOP expense. Exh. FGE-1 at 074-75. Despite some indications of improvements in the capital markets in recent months, FG&E still faced a write-

off of \$4.2 million of AML for 2003, absent the Department's approval of a regulatory asset. See D.T.E. 03-91 at 3 (Feb. 5, 2004).

Regardless of future market conditions, the approval of the proposed PAF would also provide "the equitable result that customers would pay no more than the actual costs incident to (and demanded by FASB to support) pensions and PBOP for the utility workers who provided daily service to customers year-in, year-out until retirement." NSTAR Order at 27. As the Department has recognized, meeting that obligation to utility workers "is the surest route to the workforce stability that is so necessary in this technical and specialized field and so essential for sound customer service." Id.

VI. CONCLUSION

In this proceeding, the Company has demonstrated the need for approval of its proposed ratemaking mechanism, consistent with recent Department precedent, to provide rate and earnings stability, to ensure that customers pay no more or no less than the amounts needed to provide pension and PBOP benefits to employees and retirees, and to avoid the financial impairment of the Company that arises from accounting requirements associated with the extreme volatility of pension and PBOP funding obligations. Accordingly, the Department should approve the proposed PAF tariffs, as set forth in Exhibit FG&E 1, pages 001-0026.

Respectfully submitted,

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Dated: August 30, 2004